BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)	
)	No. 82A-0196-PS
POWER-LINE SALES, INC.)	

Appearances:

For Appellant: John F. Walker, Jr.
Attorney at Law

For Respondent: Karl F. Munz
Counsel

O P I N I O N

This appeal is made pursuant to section 256661' of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Power-Line Sales, Inc., against proposed assessments of additional franchise tax in the amounts of $13,323, $11,128, and $22,437 for the income years 1974, 1975, and 1976, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

Appeal of Power-Line Sales, Inc.

During the relevant years (1974-1976), appellant Power-Line Sales, Inc., a California corporation, was engaged in the manufacture and sale of wire fasteners and staple machines throughout the United States, and in certain foreign countries through its foreign subsidiaries. In 1973, appellant was owned and operated by two brothers: R. E. Powers, who held the offices of president and treasurer, and M. E. Powers who held the offices of vice president and secretary. The Powers brothers were advised by George Roberts, a partner at Bear, Stearns & Company, an investment banking firm, that they could dispose of their interest in appellant through a "leveraged management buyout." PLS Holding Company, Inc., (PLS) was formed to acquire appellant, and in February 1973 acquired all of appellant's outstanding stock. During the relevant years, PLS had no paid employees and did not conduct any operations. Appellant alleges, however, that PLS, through its director, George Roberts,[2/] provided management services and assisted appellant in some of its investment, operational, financing and sales decisions. The activities alleged by appellant to have been performed by Mr. Roberts, as a PLS director, were:

> (a) Mr. Roberts formulated all policies and made or approved all significant decisions relating to Power-Line and its subsidiaries. No important decision was made without his approval. Mr. Roberts regularly initiated suggestions and occasionally reversed operational decisions of other local Power-Line executives.
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> (b) Mr. Roberts was closely involved in new tool development and design and in the key decisions in this area. For example, Mr. Roberts studied in detail and approved the decision to introduce "multi-wire" machines for the Power-Line production line [in] 1973. This decision was a significant one in terms of cost and operational change.

2/ George Roberts was the partner at Bear, Stearns who put the acquisition together, and later became president, treasurer and a director of PLS, and a director of appellant.

(c) Mr. Roberts' approval was required for all Power-Line capital expenditures of $2,000 or more. He requested, designed the format for, and regularly received a detailed "President's Report" from the Powers brothers, reviewing the operational activities for the relevant period. He actively and regularly monitored the financial affairs and projections of Power-Line and its subsidiaries. For example, Mr. Roberts closely managed the service of the loans from Fidelity and the Massachusetts Mutual companies relating to the acquisition of Power-Line in 1973.

(d) Mr. Roberts constantly monitored credit matters and was involved in the formulation of credit guidelines for Power-Line.

(e) Mr. Roberts negotiated and approved loan commitments and loan commitment documents during the relevant years for Power-Line. For example, Mr. Roberts negotiated and obtained a revolving line of credit from Union Bank of $500,000 in 1975 and a mortgage loan of $400,000 from Stockton White Ampersam Co.

(f) Mr. Roberts periodically visited the operating plant of Power-Line, inspected the machinery, and was familiar with the physical characteristics of Power-Line's manufacturing operations. In doing so, he asked questions of line personnel, made suggestions, and reviewed and approved major decisions of the operating managers.

(g) Mr. Roberts approved significant changes in the size of the work force of Power-Line. He personally set the salaries of the key management personnel of Power-Line and negotiated the executive contracts. He had and exercised hiring and firing power with respect to Power-Line's top executives.

> (h) Mr. Roberts closely followed the market for Power-Line products, approved all pricing decisions, and occasionally suggested names of potential customers to the Power-Line management.
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> (i) In the 1973-1975 recession, Mr. Roberts participated in discussions regarding cutting back production. He had and exercised final approval power to eliminate the third shift on January 23, 1975.
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> (j) Although Mr. Roberts' principal background was in financing and acquisitions, his activities with respect to Power-Line were balanced as to operations, marketing, financing, and personnel matters. Mr. Roberts was the equivalent of a chief executive officer during the years at issue.
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> (k) Mr. Roberts actively investigated and personally negotiated potential acquisitions for Power-Line during the relevant years, including a wire-drawing plant in Colorado, a wire-drawing plant in Texas, and a clip plant in Illinois. Of these prospects, only the North Carolina plant (sic) was actually acquired by Power-Line.

(App. Reply Br. at 8-11.)

In the relevant years there were overlapping directors between PLS and appellant, and on August 27, 1976, the Powers brothers became officers of PLS. Beginning with income year 1973, and during the relevant years, appellant and PLS filed their California franchise tax returns as a unitary group. Respondent Franchise Tax Board examined the returns for income years 1974 through 1976[3/] and determined that appellant and PLS

[3/] 1974 is not at issue because the examination was commenced after the running of the statute of limitations for this income year.

were not engaged in a unitary business during the relevant years. Appellant's protest of respondent's assessments was denied and this timely appeal followed.

If a taxpayer derives income from sources both within and without California, its franchise tax liability is required to be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472 [183 P.2d 16] (1947).)

The California Supreme Court has held that the existence of a unitary business may be established by,the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions; and unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 3343 (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942).) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California. (Edison California Stores. Inc. v. McColgan, supra, 30 Cal.2d at 481.) More recently, the United States Supreme Court has emphasized that a unitary business is a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (Container Corp. v. Franchise Tax Board, 463 U.S. 159, 178-179 (77 L.Ed.2d 545), rehg. den., 464 U.S. 909 [78 L.Ed.2d 248] (1983).)

More is required to demonstrate the existence of an integrated unitary enterprise than the recitation of a number of so-called "unitary factors." One must be able to differentiate a unitary business from a group of commonly owned businesses or activities, the operations of which really have no effect upon one another. As we said in the Appeal of Saaa Corporation, decided by this board on June 29, 1982, we must distinguish

> between those cases in which unitary labels are applied to transactions and circumstances

> which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single integrated economic enterprise.

(See also Appeal of Sierra Production Service, Inc., et al., 90-SBE-010, Sept. 12, 1990, where we said that "labels are not helpful in justifying either combination or decombination, regardless of who uses them.")

It is axiomatic that business activities conducted in multiple taxing jurisdictions are not automatically unitary merely because they are commonly owned and controlled. Because of constitutional limitations, it is necessary to differentiate between a truly integrated, unitary business, whose income is appropriately apportioned among the jurisdictions in which it is conducted, and a group of commonly owned businesses or activities, the operations of which really have no effect upon one another, and the income from which is, therefore, not properly subject to apportionment. (Appeal of Sierra Production Services. Inc., et al., supra, and the cases cited therein.)

The first part of the three-unities test is met because PLS owned 100 percent of appellant. However, unity of ownership does not render a business unitary if either unity of operation or unity of use is not present. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal.App.3d 496, 502 [87 Cal.Rptr. 239], app. dism. and cert. den., 400 U.S. 961 [27 L.Ed.2d 381] (1970).) Appellant does not point us to facts, nor have we discovered any, which demonstrate the presence of unity of operation. While appellant has asserted that Mr. Roberts, as a director of PLS, made policy decisions for appellant and its subsidiaries, his alleged activities are not sufficient to demonstrate that unity of operation is also present. The presence of interlocking directors or officers who made major policy decisions is sufficient to show unity of use if they constitute a centralized executive force. But appellant's unsupported conclusion that, "because the centralized services provided by the parent corporation and the integrated executive force were important to the subsidiaries, unity of operation was also present" (App. Br. at 10), is self-serving and does not establish the presence of unity of operation.

As we said in Anneal of Scholl, Inc.. et al., decided by this board on September 27, 1978, "When considering whether unity of operation is present, we are most impressed with the absence of the usual indicators." In the instant matter, PLS had no employees and did not engage in any operations. Accordingly, there were no centralized staff functions, no centralized purchasing, advertising, accounting or management divisions, no exchange of employees, no sharing of staff or management functions, no centralized research and development, nor other centralized administrative department functions. Thus, in the absence of these usual indicators of unity of operation, we must conclude that unity of operation between appellant and PLS was lacking during the relevant years. Having concluded that unity of operation is not present in the instant matter, we need not address whether unity of use is present, because in the absence of one of the "three unities" a business cannot be considered unitary under the "three unities test." (Chase Brass & Copper co, v. Franchise Tax Board, supra, 10 Cal.App.3d at 502; cf. Container Corp. of America v. Franchise Tax Board, 117 Cal.App.3d 988, 995 [173 Cal.Rptr. 121] (1981), affd., 463 U.S. 159 [77 L.Ed.2d. 545] (1983).)

Appellant also places reliance on Appeal of Credit Bureau Central, Inc., decided by this board on February 2, 1981. In that case, the parent corporation's only activity was the management of its subsidiaries, all of which were engaged in the collection agency business, and three of the parent company's operating officers held similar positions in each of the parent company's 14 operating subsidiaries. The parent company was largely responsible for the preparation of the group's monthly financial statements; the maintenance of an internal audit department; the preparation of annual reports for its shareholders and other regulatory requirements; the purchase of insurance for its subsidiaries; and had direct responsibility for the recruitment and dismissal of high-level subsidiary personnel. The principal facts which distinguish that case from the instant matter are the high probability of the sharing of know-how by the 14 subsidiaries through the overlapping of officers, and the dissimilar activities conducted by appellant and PLS. We have previously held that where members of an affiliated group share common officers and directors while engaging in generally the same type of business, a reasonable inference can be drawn that the affiliated group benefited from the exchange of significant information. (Appeal of Maryland Cud Cornoration, Cal. St. Bd. of Equal., Mar. 23, 1970; Aooeal of Anchor Hocking Glass

Corooration, Cal. St. Bd. of Equal., Aug. 7, 1967.) Here, appellant was engaged in the manufacture and sale of wire fasteners and staple machines, and PLS had no paid employees and did not conduct any operations; therefore, no exchange of operating information was possible. The oversight of appellant's operations by PLS was of the nature and type as would be performed by any parent in the operation of a wholly owned subsidiary. (F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 368-369 [73 L.Ed.2d 819] (1982).)

Further, the Powers brothers did not become officers of PLS until after August 27, 1976, and were the only officers of appellant throughout the relevant years. It does not appear that the officers and/or directors of PLS were also officers or directors of appellant's subsidiaries. Thus, the possibility of a mutually beneficial exchange of information and know-how between PLS and appellant and its subsidiaries through overlapping officers, as was present in Appeal of Credit Bureau Central. Inc., supra, is not present in the instant matter.

Appellant, citing Appeal of Scholl. Inc.. et al., supra, asserts that another test of a unitary business "is whether the earnings of the group are materially different from what they would have been if each corporation had operated without the benefit of its unitary connections with the other corporation." (App. Br. at 7.) Appellant misreads the statement we made in that case. The implication of the statement was that the "three unities" or the "contribution or dependency" tests would be satisfied if the group is materially benefited by the unitary connections with the other corporations, which does not create a test apart from the "three unities" or the "contribution or dependency" tests. (See also Anneal of Saga Corooration, supra.)

We now decide whether there is contribution or dependency sufficient to satisfy the contribution or dependency test established in Edison California Stores v. McColgan, supra. In the instant matter there were overlapping directors between PLS and appellant throughout the relevant years and overlapping officers from August 27, 1976. However, there was no product flow, centralized advertising, centralized purchasing,

intercompany loans[4/] nor other such activities between PLS and appellant, because PLS conducted no activities other than its oversight of appellant. While an integrated executive force has been given considerable weight in concluding that mutual contribution or dependency was present, we know of no case where the existence of contribution or dependency was found solely from the presence of an integrated executive force. Mutual contribution or dependency have been found where there was substantial interdivisional or intercorporate product flow, and an integrated executive force (Appeal of Beecham, Inc., Cal. St. Bd. of Equal., Mar. 2, 1977; Appeal of Grolier Society, Inc., Cal. St. Bd. of Equal., Aug. 19, 1975), and where there was substantial vertical integration, an integrated executive force, and other unitary relationships. (Appeal of Nippondenso of Los Anaeles, Inc., Cal. St. Bd. of Equal., Sept. 12, 1984.) When we compare the cases where the existence of a unitary business was established by satisfaction of the mutual contribution or dependency test to the instant matter, we are convinced that the interrelationship between PLS and appellant is insufficient for a finding that they conducted a unitary business under this test.

Here, appellant argues that PLS was engaged in the business of providing valuable management and related services to appellant and its subsidiaries through a single director of PLS, who was also a director of appellant. While the facts show that this PLS director provided some executive services to appellant, there is no indication that the services he provided were provided in any capacity other than as a director of appellant. Appellant also states that it provided services to PLS, but does not state what they were. In order to establish a unitary business, it is necessary to do more than simply list circumstances which are considered to be "unitary factors"; such factors are distinguishing features of a unitary business only

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4/ The record indicates that PLS did not receive any dividend income, and incurred a substantial amount of interest expense for 1974, 1975, and 1976, which we believe related to its acquisition debt. Further, appellant did not receive any interest income. (Res. Br., Ex. B-l, B-2, B-3.) Therefore, since PLS's receipts were insignificant, and there was no intercompany debt or distribution reflected in the records of either entity, we believe the acquisition debt was directly paid by appellant.

when they show that the corporation or divisions involved functioned as an integrated enterprise and did not constitute merely a group of investments whose operations were unrelated. (See Container Corp. v. Franchise Tax Board, supra, 463 U.S. at 178; Twentieth Centurv-Fox Film Corporation, 89-SBE-007, Mar. 2, 1989.) In our opinion the factors relied upon by appellant demonstrate nothing more than a passive holding company's oversight of its unrelated investment. (Appeals of Hollvwood Film Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 31, 1982; Appeal of J. B. Torrance, Inc., Cal. St. Bd. of Equal., May 8, 1985; Appeals of Andreini & Company and Ash Slouah Vinevards. Inc., Cal. St. Bd. of Equal., Mar. 4, 1986.)

In view of the above, we must sustain respondent's position. Having decided that appellant and PLS did not operate a unitary business under the tests above, we need not address respondent's alternative argument that even if appellant and PLS were unitary, the acquisition debt expense may not be deducted from business income.

Appeal of Power-Line Sales, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Power-Line Sales, Inc., against proposed assessments of additional franchise tax in the amounts of $13,323, $11,128, and $22,437 for the income years 1974, 1975, and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 5th day of December, 1990, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Bennett, and Mr. Davies present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

John Davies*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9